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A Guide To Limited Liability Companies

How to form your LLC



- ***Reduce Your Taxes***
- ***Protect Your Assets***
- ***Minimize Your Liability***
- ***Build Business Credibility***

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LegalZoom's LLC Service

The Limited Liability Company has grown in popularity as more and more entrepreneurs discover its benefits and flexibility. Like other formal business structures, LLCs offer liability protection and tax savings, but unlike corporations, they are relatively easy to maintain. The LLC's simplicity and ease-of-use make it an ideal choice for businesses with just one or many members.

LegalZoom.com can help you quickly and easily form a new LLC or convert an existing business. With our easy 3-step process, you can set up your LLC from the home or office for as little as **\$139 plus state fees**.

1. Complete an Online Questionnaire

Answer a few simple questions online. It should take you less than 15 minutes.

2. We File the LLC Papers

We prepare the required documents and file them with the proper state agency.

3. Your LLC is Complete!

We deliver the filed Articles of Organization to you, along with a customized Operating Agreement. We can even obtain your Federal Tax ID Number.



This guide is designed to help you decide if an LLC is right for your business. You'll learn about the unique benefits of the LLC, the differences between LLCs and other common business entities, tax-saving options, and requirements for maintaining your LLC. For additional questions, our Business Formation Specialists are available to assist you at **(888) 381-8758 M-F 6:30am-6pm PST**. Or, if you're ready to start your LLC now, simply go to www.legalzoom.com.

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Introduction

All business owners want to save money in taxes and reduce their personal risk. Forming an LLC is a smart way to accomplish both of these goals without adding a lot of extra paperwork and corporate formalities. Even if you are running a business with just a single employee (yourself), you can still take advantage of these benefits by converting your sole proprietorship or partnership to an LLC.

A Word about Sole Proprietorships and General Partnerships

Sole proprietorships and general partnerships are two of the simplest and least expensive forms of business. If you currently operate a small business by yourself and report your income on a Schedule C, then you are a sole proprietor. If you are currently in business with one or more partners, then you are automatically part of a general partnership. Most new small businesses are either sole proprietorships or general partnerships. The reasons are obvious enough. Both types of business are easy to maintain and cost very little to set up. But a number of other factors can make these the **most expensive** business structures over the long run.



“Sole proprietorships can be the most expensive type of business over the long run.”

For starters, as a sole proprietor you put your personal assets at risk for liability. You also miss out on significant tax savings and enjoy fewer options for growing your business. Sole proprietorships are also much more likely to come under scrutiny by the IRS. And finally, when it comes time to sell or hand down your sole proprietorship, you'll find that the process is complicated and time-consuming.

Limited Liability Companies

The Limited Liability Company, or LLC, is a relatively new type of business structure that combines the best features of the corporation with those of the sole proprietorship or partnership. **The primary advantage of an LLC is that it affords its members the personal liability protection of a corporation, but without all of the corporate formalities.**

LLCs also have the flexibility to be taxed as a corporation or as a “pass-through entity,” similar to a sole proprietorship or general partnership (for more on pass-through entities, see the **Tax Flexibility and Savings** section below).

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Advantages of Forming an LLC

Liability and Asset Protection

As a sole proprietor, you and your business are legally inseparable. In other words, your company's debts are legally *your* debts. And a lawsuit brought against your business is also a lawsuit brought against *you*. This means your home, car, savings and investments could all be taken from you should your business get sued or go into debt. In a general partnership, the risk is even greater. This is because each partner can independently make decisions that impact the partnership as a whole. If one partner makes a bad decision, both partners are on the hook for the entire amount of any damages.

By contrast, an LLC is viewed as a legally distinct entity. If your business hits hard times, you are not personally held responsible for any debts or court judgments. Moreover, if your business goes under, you won't have to carry your business debts over to your next venture. Whatever your line of business, protecting yourself against personal liability can help you avoid a potentially disastrous situation.



"If your business hits hard times, you are not personally held responsible for any debts or court judgments."

NOTE: While LLCs can protect you from personal liability, this protection is not absolute. You and other LLC members may be liable for the debts of an LLC if:

- You personally guarantee a debt.
- You intermingle personal funds with LLC funds.
- Your LLC has minimal capitalization or minimal insurance.
- Your LLC fails to pay state taxes or otherwise violates state law.

Tax Savings & Flexibility

When it comes to taxes, LLCs offer the most flexibility. LLCs have the option of being taxed as a "pass-through" entity (like a partnership or sole proprietorship) or as a regular C-corporation. By default, your LLC is automatically recognized by the IRS as a pass-through tax entity. In other words, it "passes" income, deductions, losses, gains and tax credits directly through to you. These amounts are reported on your individual returns, and you pay taxes at your individual tax rate. In addition, if you actively participate in running your LLC, you are allowed to deduct operating losses against your regular income.

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LLC members are not required to pay unemployment insurance taxes on their own salary. However, members must pay self-employment taxes on any salary they receive and on any company profits allocated to them.

Ease of Transfer

Ownership interests in an LLC may generally be sold to third parties without disrupting the continued operation of the business. On the other hand, selling interests in a sole proprietorship or general partnership requires much more time and effort. An owner must individually transfer assets, business licenses, bank accounts, permits and other legal documentation.



“If you have plans to one day pass down your family business, an LLC can help smooth the transition.”

If you have plans to one day pass your family business down to the next generation, converting your sole proprietorship to an LLC can help smooth the transition. Legally speaking, as a sole proprietor your business is inseparable from you, which means when you die, your business dies along with you. Without converting your business to another business structure or implementing some very sophisticated estate planning strategies, your heirs will have a very difficult time inheriting your life's work.

Other Benefits

An LLC has no ownership restrictions.

As an LLC, your business can retain any number of members. By comparison, S-corporations cannot have more than 100 stockholders, and each must be a resident or citizen of the United States. None of these restrictions apply to an LLC.

An LLC provides living trust flexibility.

As a member of an LLC, you are free to place your membership interests into a living trust for your beneficiaries. By contrast, placing shares of an S-corporation into a living trust is extremely difficult.

An LLC makes it easier to raise capital.

As an LLC, you have more options available to raise capital. You can admit new members by selling membership interests. You can even create new classes of membership interests with different voting or profit characteristics.

An LLC offers greater credibility.

As an LLC, your business will enjoy legitimacy and greater credibility when dealing with other companies, banks and potential partners.

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Real Estate Investments and LLCs

In recent years, LLCs have become the entity of choice for real estate investments. Liability protection is the primary reason most people choose to place property in a business entity. And while both corporations and LLCs offer this key benefit, the LLC's tax structure and ease-of-use make it especially advantageous for real estate ventures. Consider the following advantages:

Double Taxation

C-corporations are subject to double taxation – once at the corporate level, and once again when dividends are distributed to shareholders.

Capital Gains Tax Treatment

The preferential 15% long-term capital gains tax rate is not available to C-corporations. Instead, any corporate profits from the sale of real estate are taxed at the regular corporate income tax rate (up to 35%). Furthermore, when the corporation distributes the sale proceeds to the shareholders, the shareholders are taxed on the dividends.


“Many real estate investors choose to place individual properties in separate LLCs to further limit their liability.”

Limits on Passive Income by S-corporations

Although the sale of real estate by an S-corporation may qualify for capital gains tax treatment (and is not subject to double taxation), an S-corporation may lose its special “S” tax status if its passive income exceeds 25% of gross receipts. In other words, if an S-corporation collects only passive rental income, the IRS could revoke its “S” status, rendering it a traditional C-corporation for tax purposes. Furthermore, the excess passive income would automatically be taxed at the highest corporate rate of 35%.

Separate LLCs for Enhanced Liability Protection

Many real estate investors choose to place individual properties in separate LLCs to further limit their liability. With separate LLCs, a liability incurred by one property (e.g. a lawsuit) would not affect the other properties in the investor's portfolio. The LLC's minimal maintenance and ease-of-use make this sophisticated strategy both cost-effective and simple to employ.

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Operating and Maintaining an LLC

While an LLC is generally much easier to maintain than a corporation, some regular record keeping and government filing is required to keep your LLC in good standing with the state.

Operating and Maintaining an LLC

Because an LLC is a distinct legal entity, all LLC finances and transactions must be kept separate from the personal finances of LLC members. Therefore, it is essential that you establish a separate bank account for your LLC and pay all expenses, as well as profit payouts, from this account. In addition, written records should be kept of all major LLC decisions. If you have employees, you must also obtain a separate Federal Employer Identification Number. As an optional service, LegalZoom can prepare your FEIN application or even obtain your FEIN number for you.

Annual Reports

After the initial government filings, most states require an LLC to file a short annual report form with the same state office where the Articles of Organization were filed. These forms typically require basic information, such as names and addresses of current LLC members and/or managers. They might also request the name and address of the LLC's registered agent and the office for service of process. In most states, a filing fee is required with the annual report.

Tax Returns

Income tax filings will vary depending on whether you choose pass-through tax treatment or you make a special election to receive corporate tax treatment.

LLCs with Pass-through Tax Treatment

If you are the only member of your LLC, the LLC will not have to file any forms. Instead, you'll report all your income or losses on your personal IRS 1040 form and attach a Schedule C, Profit or Loss from a Business. You will also need to file a Schedule SE, Self-Employment Tax Return.

If your LLC has multiple members, you and your co-members will report your individual incomes from the LLC on your individual tax returns. In turn, the LLC is required to file an informational return using IRS Form 1065. Attached to this form should be a Schedule K, which is used to report the profits, losses, credits and deductions allocated to the members of the LLC. In addition, the LLC must file a Schedule K-1 for each member and report that member's share of the profits and losses.

LLCs with Corporate Tax Treatment

Your LLC can elect corporate tax treatment by filing IRS Form 8832. Once filed, the IRS will treat your LLC as a separate tax entity. The LLC will then have to file a corporate tax return, IRS Form 1120, Corporate Income Tax Return, and estimate and pay its own taxes at the appropriate corporate tax rate.

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Where Should I Form My LLC?

Most people choose to form their LLC in their home state because it's the easiest and often the most cost-effective option. If you form an LLC in a different state, you often need to register your company in your home state, which requires a separate filing fee and subjects you to your home state's taxes. In addition, by forming your LLC in your home state, you can save money by serving as your own registered agent.



“LegalZoom.com can help you form an LLC in all 50 states.”

Delaware, Nevada and Other “Business-Friendly” States

If your home state has a high corporate income tax or high state fee, and your LLC will not “do business” in your home state, it may be wise to form your LLC in a tax-free state. Nevada does not have a state income tax, and Delaware does not tax out-of-state business activities.

Typically, this strategy works best with businesses that have offices in multiple states or those that serve as passive investment companies. “Doing business” means more than just selling products or making passive investments. It usually requires occupying an office or otherwise having an active business presence.

Furthermore, by forming your LLC in a different state, your company becomes subject to the corporate laws of that state. Delaware and Nevada are known for their business friendly laws and courts. While it is possible to reduce your taxes by this method, we recommend that you consult with a tax adviser to see if it is appropriate for your business. LegalZoom can help you form an LLC in all 50 states.

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How LLCs Compare to Other Business Structures

Although LLCs offer many benefits, they are not the right choice for every type of business. When choosing a business structure, it's important to understand the differences between common business entities. The following section compares the LLC to other common business entities and highlights the advantages and disadvantages of each. As always, it is a good idea to consult a tax professional before making a decision that has tax implications for your business.

LLCs Compared to C-Corporations

- **Fewer corporate formalities.** C-corporations are required to have director and shareholder meetings. LLCs are not required to do so.
- **Simpler management structures.** C-corporations must have a Board of Directors but LLCs are not required to have them.
- **Ease of transferring interest into a living trust.** Placing your company interest in a living trust can be accomplished more easily for members of an LLC than for a C-corporation.
- **Tax flexibility.** C-corporations are subject to double taxation. Double taxation occurs when shareholders pay taxes on their salary at the same time that the corporation pays taxes on its profits.
- **Cash method of accounting.** LLCs are able to use the cash method of accounting, which means that income is not considered earned until it is received. In contrast, C-corporations must use the accrual method of accounting, which means that income is considered earned when the project is complete – and often before payment is received.
- **Loss deduction.** Members who are active participants in the business of an LLC are able to deduct its operating losses against their regular income to the extent permitted by law. Shareholders of C-corporations are not able to deduct operating losses from their income.
- **Profit recognition.** A C-corporation does not have to immediately distribute its profits to its shareholders in the form of a dividend. This means that shareholders in a C-corporation are not always taxed on the corporation's profits. Because an LLC is treated as a pass-through entity, the profits of the LLC are automatically included in a member's income.
- **Fewer fringe benefits.** Employees of an LLC who receive fringe benefits, such as group insurance, medical reimbursement plans, medical insurance and parking, must treat these benefits as taxable income. The same is true for employees who own more than 2% of an S-corporation. However, employees of a C-corporation who receive fringe benefits do not have to report these benefits as taxable income.

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LLCs Compared to S-Corporations:

- **Fewer corporate formalities.** Corporations must hold regular meetings of the board of directors and shareholders and keep written corporate minutes. On the other hand, the members and managers of an LLC need not hold regular meetings, which reduces complications and paperwork.
- **Simpler management structure.** LLCs are not required to have a formal Board of Directors (known as “Managers” in an LLC). The owners and officers of an LLC can make all important company decisions directly.
- **No ownership restrictions.** S-corporations cannot have more than 100 stockholders, and each stockholder must be a resident or citizen of the United States. There are no such restrictions placed on an LLC.
- **Potential Tax Disadvantage.** An LLC does not enjoy the same self-employment tax savings as an S-corporation. Instead, single member LLCs must pay self-employment tax on both salary and profit. However, an LLC can make an election with the IRS to be treated like a corporation for tax purposes.
- **Greater Acceptance of Corporations.** Since limited liability companies are still relatively new, not everyone is familiar with them. In some cases, banks or vendors may be reluctant to extend credit to LLCs. In addition, some states restrict the types of business an LLC may conduct.

LLCs Compared to Limited Liability Partnerships (LLPs)

- **Limited Liability for Malpractice.** While an LLC provides limited personal liability, it does not provide protection for members from the malpractice of other LLC members. With an LLP, professionals are protected from the malpractice of their partners.
- **Distribution of Profits.** LLCs cannot make distributions to members if doing so would make the business insolvent—that is, unable to pay its debts as they become due. An LLP has no such limitations.

LLCs Compared to Limited Partnerships (LPs)

- **Debt liability.** In an LLC, all members are automatically covered by the cloak of limited liability protection. In contrast, an LP must have at least one general partner who is personally liable for the debts and other liabilities of the business.
- **Managing the business.** In an LP, Limited Partners are generally prohibited from managing the business. In fact, becoming active in the business of the LP can cause a Limited Partner to lose his or her limited liability. In an LLC, all members can freely manage and run any aspect of the business without running the risk of losing their limited liability.

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Business Entity Comparison Chart

	Limited Liability Company	Sole Proprietorship / General Partnership	S-corporation	C-corporation
Formation	State filing required.	No filing required, unless doing business under an assumed name.	State filing required; Subchapter S election typically must be made within 60 days of formation	State filing required.
Personal Liability	Members are not typically liable for the debts of the LLC.	Owners have unlimited liability.	Shareholders are typically not personally liable for corporate debts.	Shareholders are typically not personally liable for corporate debts.
Formalities and Record-Keeping	Formal meetings and minutes are not required; however annual state reports are required.	Relatively few legal requirements.	Formal board and shareholder meetings and minutes are required, and annual state reports required.	Formal board and shareholder meetings and minutes are required, and annual state reports required.
Management and Operation	Management is flexible, like a partnership; typically, an operating agreement outlines management duties. A board of managers is optional.	Sole proprietor has full control. Partnerships have a flexible management and operational structure.	Managed by the directors, who are elected by the shareholders; directors appoint officers, who run the day-to-day operation.	Managed by the directors, who are elected by the shareholders; directors appoint officers, who run the day-to-day operations.
Taxation	By default, there is no tax at the entity level; income/loss is passed through to members, like a sole proprietorship or partnership	Not a separate taxable entity. Income/loss is passed through to the owners	No tax at the entity level. Income/loss is passed through to the shareholders	Taxed at the entity level. If dividends are distributed to shareholders, dividend income is taxed at the individual level.
Tax Reporting	See Sole Proprietorship/ General Partnership; LLCs may also elect to be taxed as a C- or S-corporation.	Sole Proprietorships: All income is reported on Form 1040, Schedule C. Partnerships report income on Form 1065, with profit distributions on Schedule K-1.	S-corporations report income on Form 1120S, with salaries reported on Form W-2 and profit distributions on Schedule K-1.	C-corporations report income on Form 1120, with salaries reported on Form W-2 and any profit distributions on Form 1099-DIV.
Recommended for:	Owners wanting the liability protection of a corporation with less corporate formalities, and the simplicity of pass-through taxation of income.	Owners wanting minimal formalities, maximum flexibility, and not worried about personal liability.	Owners wanting the liability protection of a corporation, with the simplicity of pass-through taxation of income.	Owners needing maximum tax and ownership flexibility, combined with liability protection.

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Why Choose LegalZoom.com to Form Your LLC?

LegalZoom.com is America's leading online legal document and filing service. From business formations to estate planning tools, LegalZoom makes it easy to take care of a variety of common legal matters without an attorney. Along with professional-quality legal documents, our customers enjoy free attorney referrals, a 24-hour online legal education center, and a range of complementary business and tax resources.

LegalZoom.com's business formation services include LLCs, Corporations, LPs, LLPs, and Non-Profit Organizations. We also offer a number of essential business services such as DBAs and Seller's Permits.

Our simple, three-step process begins with an easy online questionnaire. Next, our specialists prepare your legal documents and file them with the appropriate government agency.

When you're ready to form your LLC or take advantage of our other business formation services, visit us online at www.LegalZoom.com.

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